

# CROSS-BORDER INTEREST RATE SWAPS AND THEIR TREATMENT FOR REGULATORY AND TAX PURPOSES



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## **Abstract**

*Financial derivatives are complex products of financial engineering. The interest rate swap is a very good example of widely used and very intricate two-way payments financial derivative. Interest rate swaps as other financial innovations posed a number of issues for legal systems and regulations. Among other problems there are problems of substance over form approach, the problem of classification for regulatory purposes, the issues of the replication of traditional financial instruments' economics.*

*The Application of regulations to interest rate swaps and other financial derivatives require the nature and context understanding of the transactions. It seems that separate transaction method is*

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*a prevailing approach to financial innovations. It implies that derivatives should be treated separately from underlying assets and obligations and should not be bifurcated to their economic components as well. Legal differences are not less important than economic similarities.*

*The example of interest rate swap shows the opportunity for re-characterisation of transaction in cross-border situations for general civil law purposes (gambling, insurance), for regulatory and tax purposes.*

### **Keywords**

*Financial law, derivatives, financial instruments, swap, international finance, taxation, transaction re-characterisation*

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## **TABLE OF CONTENTS**

I. Legal nature of interest rate swaps . . . . .	199
II. Replication of traditional financial instruments . . . . .	202
III. Legal classification and substance v. form problem . . . . .	205
Conclusion . . . . .	207
References . . . . .	208

## **I. LEGAL NATURE OF INTEREST RATE SWAPS**

The principles behind financial transactions are simple enough. It is usually the detail that confuses by obscuring the principles.<sup>2</sup>

In general, derivative financial instruments (as suggested by the term) “derive” their value from other financial instruments or indices. Usually derivatives include forward contracts, futures, options, or different kinds of swaps. Derivative financial instruments can be traded in the market or tailor made for particular parties (so called “over the counter” instruments), or they can be embedded in another financial transaction or instrument, even a traditional one.

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<sup>2</sup> Michael Brett. How to read the financial pages. 5<sup>th</sup> ed. London: Random House Business Books. 2000. P. 285.

There is a general issue, that derivatives are “interdependent” and sometimes represent an economics of traditional financial instruments. Derivatives can be used consciously to replicate the cash flows of other types of financial transactions or they can inadvertently appear to be the economic equivalent of other types of financial transactions. Accordingly it may be difficult to categorise derivatives for the purposes of applying laws relating to enforcement, regulation or taxation. The expansion of derivatives methodology throughout the system, however, provides further challenges. Sometimes it is still not clear what fits into what place. Many laws relating to “derivatives” do not provide blanket treatment of all derivatives but relate to specified products, often providing for the inclusion of other similar agreements.

Under the swap agreement two parties are exchanging cash flows in over certain interval of time calculated by reference to a specified index upon a notional principal.

Swap contracts can derive their value from a price of certain commodity — commodity swap, from equity — equity swap or from interest rate — interest rate swap.

The essence of the interest rate swaps can be summarised as follows.

The form in which borrowers can most easily raise money is not always the form best suited to their purposes. The solution may be a swap. Suppose we have two companies, for one of which it is easier and cheaper to borrow fixed-rate, but it needs floating rate borrowing and for the other which can borrow cheaper floating rate, it would be more desirable to borrow fixed rate. The first company borrows with fixed interest and another borrows floating-rate. They agree to swap their interest payment liabilities. Company A pays the floating-rate interest due on Company B’s loan and Company B pays the fixed rate of interest on the Company A borrowing, with some adjustment to reflect the relative strength of the two concerns. By this mechanism, each ends up with money in the form in which it needs it, at a cheaper rate than if it had borrowed what it needed directly.

This is the principle: each company borrows the money in the form in which it has the greatest relative advantage. In reality these mechanisms are more complex. Companies will not normally seek the counter-party for the swap directly, but will arrange a swap with a bank, which can either find a counter-party for the deal (taking a small spread

in the middle) or may act as counter-party itself. And swaps, once set up may be subsequently traded or adapted as conditions change in the market.

Comparative advantage theory is one of the explanations of swap transactions. Counterparties in a swap have a comparative advantage in a particular credit market and that advantage in one market is used to obtain an equivalent advantage in a different market the access to which was otherwise denied. The advantage can be the possibility to borrow cheaper in a particular market, to obtain funds which are not available for the counterparty or overcome the regulations of particular market which prevents one party from borrowing in this market. The counterparties can then exchange their risks, hedging the underlying transaction or they can just exchange cash flows without any purpose other than speculating in the market. There are also different uses of the interest rate swaps, among which there are those related to tax planning, which are sometimes rather aggressive.

The typical interest rate swap agreement obligates the first party to pay an amount equal to the interest which would accrue on an agreed amount during a given period at one type of interest rate and obligates the second party to pay an amount equal to the interest which would accrue on that agreed about during the period at another type of interest rate.

The interest rate swap involves only the exchange of payment not principal but rather the (notional) amount. The only relevance of notional amount is for the calculation of the payments due. The parties can agree, that the one with the fixed rate payment obligation will make an upfront payment for a certain period. For example if a fixed payment amount is calculated for 1 month is \$ 100, one party can agree to make an upfront payment for 10 months of \$ 1 000.

Parties to an interest rate swap agreement have the right of early termination on the Event of Default and on the Termination Event, both specified in the particular contract and subject to certain procedures. There may be two types of payments under interest rate swap:

- Payment of the amount resulting from netting on a specified period of time.
- Payment on early termination.

The payments under interest rate swap may be periodic and non-periodic.

Periodic payments are those, made after the netting of obligations during a specified period of time. Non-periodic payments are those made on early termination and upfront payments or any payments other than periodic.

In real life it is difficult to find two parties with matching requirements, therefore, usually, there is an intermediary — bank or other financial institution between the two parties (“end users”). The financial intermediary will become a counterparty for the end user A and the end user B (who swap their “comparative advantages”, risks etc.) and take a profit on the difference.

Cross border interest rate swaps are usually documented on the base of standardised contracts. In order to facilitate the market of swaps the International Swaps and Derivatives Association (formerly International Swap Dealers Association) suggested a standardised documentation for cross border swap transactions — the ISDA Master agreement.

## **II. REPLICATION OF TRADITIONAL FINANCIAL INSTRUMENTS**

One of the features of derivatives is that they can fully or partially replicate the economics of other traditional financial instruments or their combination.

One of the most important factors which can be replicated is pricing. It is possible to replicate the same payments profile of a particular instrument by combining together other instruments or by unbundling certain features of another instruments.<sup>3</sup> Derivatives can be used to create a position where the cash flows under derivative may be identical to the cash flows, which would be generated by traditional, sometimes underlying instruments. In case of interest rate swap interest flow can be replicated by swap payments.

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<sup>3</sup> Alworth J. Taxation and integrated financial markets: the challenges of derivatives and other financial innovations. *International tax and public finance*. 1998. 5 (4). Pp. 507–534.

The rate which two parties would agree to pay on the notional amount is a mathematical formula rather than a guess of parties. If the future interest rate cannot be known in advance, the market does possess a lot of information concerning the yield generated by existing instruments over future periods of time and it does have the ability to calculate forward interest rates, which will always be at such a level as to eliminate any arbitrage profit with spot interest rates. Pricing of interest rate swap may be similar to the pricing of loans.

The similarity in a loan pricing and an interest rate swap and thus possibility to replicate a loan appears to be an argument for treatment of some payments under interest rate swaps in the same way as interest for regulatory and tax purposes.

Derivatives permit end-users and dealers to identify, to isolate, and to manage separately the fundamental risks and other characteristics that are bound together in traditional financial instruments. The Group of Thirty identified the following uses of financial derivatives including interest rate swaps for end-users and institutional investors.

End-users:

Lowering funding costs through the arbitrage technique by taking advantage of differences that exist between capital markets.

Diversifying funding sources. Obtaining financing from one market and then swapping all or part of the cash flows into the desired currency denominations and rate indices. The issues can diversify their funding activities across global markets without selling or buying any other securities.

Funding operations in multiple countries at lowest cost. International corporations need to borrow in a particular country but only a small amount which makes it not viable if made directly due to the costs. It may be cost effective however, to borrow more than they need in those capital markets and swap excess debt into the other needed currencies.

Hedging the cost of anticipated issuance of fixed rate debt. Volatile interest rates create uncertainties about the future cost of fixed rate debt. Swaps can be used to “lock in” the fluctuation of interest rates that exists at the time the funding decision is made.

Managing existing debt or asset portfolios. Companies may need to change the characteristics of its existing portfolio of debt securities or mix fixed and floating rate debt or the mix of currency denominations.

Financial institutions may use the derivatives also for other purposes:

Enhancing Yields through Arbitrage opportunities. Institutional investors use derivatives to create different investments with a higher yield than corresponding traditional investments.

Managing exposures to alternative assets Institutional investors have recently begun to use derivatives, especially interest rate and equity swaps, to manage their exposure to debt and equity markets both domestic and international.<sup>4</sup>

There are certain “tax uses” of interest rate swaps both domestic and international, some of which could be considered abusive. The interest rate swaps with large up-front payments were widely used in the USA in order to use the net operating losses beyond the time-limits deducting up-front payment immediately to offset other taxable income.<sup>5</sup>

Swaps can be used to avoid rules related to the taxation of interest. For example, a company may wish to borrow its own local currency but instead borrows in a lower interest currency and enters a swap agreement under which it receives swap payments based on that lower interest rate but makes swap payments based on the higher rate of interest in its local currency. By entering the swap instead of borrowing directly in the higher interest currency the borrower has replaced interest payment which might have been subject to withholding tax or thin capitalisation rules by deductible swap payments which are not treated as interest, even though they perform a similar economic function to interest.<sup>6</sup>

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<sup>4</sup> Scott S. and Wellons P. Group of thirty, *Derivatives: practices and principles*. In: *International finance: transactions, policy and regulation*. 7<sup>th</sup> ed. New York. 2000. Pp. 34–43.

<sup>5</sup> Bruce A. E. *The recharacterisation of cross-border interest rate swaps: tax consequences and beyond*. *Florida Tax Review*. 1995. 2-11. Pp. 32–21.

<sup>6</sup> Example given in the OECD Report “Taxation of new financial instruments”, (1994) OECD, at 13 (n. 36).

### **III. LEGAL CLASSIFICATION AND SUBSTANCE V. FORM PROBLEM**

Perhaps not surprisingly such complex transactions pose problems and experience many uncertainties in cross-border situations.

The legal characterisation of the financial derivatives, including interest rate swaps is not agreed yet. It is general concern for the interest rate swaps, that they are exposed to recharacterisation by courts in different jurisdictions.

First of all, the transactions can be re-characterised under the civil laws. Interest rate swaps can be considered an insurance transactions or gambling contracts. Recharacterisation problem related to the restrictions for insurance companies to enter in other businesses including financial instruments and restrictions for unauthorised entities to enter into insurance contract. Credit default swaps may be regarded as a guarantee contract.

The swap derivatives were already challenged in courts in different jurisdictions and their nature was discussed, but the outcome of this kind of transactions is still uncertain both in terms of civil law and in terms of financial regulations and tax treatment. The possible re-characterisation of a contract or certain payments should be born in mind categorising the income under transaction for tax purposes especially in cross-border situations.<sup>7</sup>

Substance and form problem can be considered as a corner stone issue for most of the financial transactions.<sup>8</sup> Derivative financial instruments in general and interest rate swaps transactions are just the most extreme examples of this.

The issue is how law and practice should treat this two-in-one reality. The problem of classification of different financial products for regulatory purposes is further complicated by the existence of different underlying assets, the differences in uses and motives of the parties to enter into swaps. As it was stated above, very often parties enter into

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<sup>7</sup> Kudryashova E. The Logic and Issues of International Regional Tax Integration. Russian Law: theory and practice. 2016. 2. Pp. 42–47.

<sup>8</sup> Shashkova A. Financial & Legal Aspects of Doing Business in Russia. M., 2011. P. 51.



swaps in order to hedge other outstanding transactions or pursuing some other speculative purposes.

The substance of a swap could be split into external economic substance and internal economic substance. External economic substance means that the swap is located in broader transaction context (to accompany transactions linked economically but being independent legally) and becomes visible only if one looks beyond the legal form towards its motivating economic purpose. Internal economic substance means that the swap shall be viewed as a compound consisting of certain transaction components which legally exist in one agreement and are independent economically. In order to identify internal economic substance the swap shall be disintegrated into fragments if it is possible.

The step towards external economic substance from the form would require that the group of instruments, which lead to the same economic result, would be treated as one eliminating, mismatching in timing, source, with the character of several linked transactions.

The step towards internal economic substance from the form would require that a single financial product is viewed as a compound consisting of the parts and the tax status of each part should be established separately.<sup>9</sup>

The problem of substance versus form for interest rate swaps is relevant for taxation issues, for the purposes of accounting, capital adequacy<sup>10</sup> and global trading. Professor Southern suggested in his article,<sup>11</sup> that there was an extensive consensus in favour of the separate transactions principle for regulatory purposes. Some deviations from this may be made in defined circumstances to recognise hedging or to analyse risk for capital adequacy purposes. There is a similar consensus that multi-component transactions should not be assimilated to a single whole.

The separate transaction approach could be favoured also for the stability of regulation reasons. Financial instruments are developing

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<sup>9</sup> Southern D. The taxation of derivatives. BTR. 1998. 4. P. 349.

<sup>10</sup> Shokhin S. Finansovoye pravo — vremya peremen [Financial law is the time of changes]. Finansovoye pravo. 2014. 2. Pp. 3–5.

<sup>11</sup> Southern D. The taxation of derivatives. BTR. 1998. 4. P. 347.

very fast and now we not only two-tier transactions linked to one underlying transaction, but also three-tier transactions, like swaptions (swaps plus options). The “context” of such three-tier transaction can involve more than one underlying asset or obligation.

The separate-transaction approach could be justified also on the grounds that it would be practically difficult to prove, for example the hedge motive, i.e. the connection to a hedged item. Not only can one transaction be hedged, but a series, or hedging can be of an “overall book so that except when a swap was first into it would not have been possible to match a transaction with its hedge.”<sup>12</sup>

## CONCLUSION

New financial instruments are very difficult to classify and each product is scrutinised by authorities and courts. A court may re-characterise a tax-motivated or other regulatory-motivated transaction and courts in different jurisdictions seem to be willing to re-characterise “artificial” finance schemes for taxation or other regulatory purposes. If this approach becomes prevailing, swaps with loan-like features would run the risk of being re-qualified if the swap transaction ever become the subject of a court proceeding.

The central issue in interest rate swaps for the purposes of regulation is substance versus. form issue. This issue doubles as for the re-characterization purposes both external substance approach and (integration) internal substance approach (disaggregation) are applied. The tax approach to the swap’s external economic substance clearly tends towards integration, which would mean for example, recognition the hedging motives of transactions and consideration swaps together with the underlying assets. The taxation of the swaps according to its internal economic substance is developing towards fragmentation of swap into its different components.

Strict substance-driven approach is undesirable and sometimes difficult to apply in respect of financial derivatives. The substance-driven approach can lead to the ignoring of legal distinctions. Although,

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<sup>12</sup> South Tyneside BC v. Svenska International Handelsbank (1995) discussed in: Southern D. The taxation of derivatives. BTR. 1998. 4. P. 344.

legal differences are not less important than economic similarities. The most adequate approach is separate transaction approach, which implies that interest rate swap should be considered as such, not being divided into constituting parts or integrated with other transactions. The treatment of swap as separate transactions gives certain level of stability for the transaction parties.

We have to admit that derivatives are ever exposed to so called “regulatory risk”. Parties and their financial advisers should remain ever-vigilant of these risks in the design of structured financial transactions and in the development of financial products.

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